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ALTERNATIVE RATE MAKING
MECHANISMS FOR WATER AND
SEWER

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PUBLIC UTILITY COMMISSION
PUBLIC UTILITY COMMISSION
OF TEXAS

STAFF STRAWMAN RULE

The staff of the Public Utility Commission of Texas (commission) requests comments on a strawman rule proposed under Texas Water Code §13.183(c), which allows the commission to adopt rules related to specific alternative ratemaking methodologies for water and sewer rates to allow for more timely and efficient cost recovery. The strawman proposes repealing existing 16 Texas Administrative Code (TAC) §24.75 and adopting new 16 TAC §24.75, which addresses the same subject matter but includes changes to the cash needs method and multi-step rate changes. The strawman also adds a new subsection regarding the creation of new customer classes to proposed section §24.75. Furthermore, the strawman proposes adoption of a new section, 16 TAC §24.76, addressing system improvement charges.

The strawman rule can be accessed through the interchange on the commission's website using Project Number 50322. Staff invites written comments on the strawman rule. At the time of this filing, the commission's rules requiring that pleadings or documents be physically filed are suspended. *See* Project No. 50664, *Issues Related to the State of Disaster for Coronavirus Disease 2019*, Second Order Suspending Rules filed on July 16, 2020. As long as this suspension remains in effect, comments may be filed through the interchange on the commission's website. If the suspension of these rules is lifted during the pendency of this project, comments may be filed by submitting 16 copies to the commission's Filing Clerk, Public Utility Commission of Texas, 1701 North Congress Avenue, P.O. Box 13326, Austin, Texas 78711-3326. The deadline for all comments on the strawman is 3 pm on December 11, 2020. Comments should be organized in a manner consistent with the organization of the rule. All responses should reference Project Number 50322. The parties' responses to the strawman will assist staff in developing a proposed policy and proposed rules in this area.

Questions concerning this notice should be referred to Emily Sears, Financial Analyst, Rate Regulation Division, (512) 936-7224. Deaf and hard of hearing individuals with text telephones (TTY) may contact the commission through Relay Texas by dialing 7-1-1.

1 **§24.75 Alternative Ratemaking Methodologies. [REPEAL]**

2 **§24.75. Alternative Ratemaking Methodologies.**

3 (a) **Purpose** This section establishes alternative methodologies for establishing rates that the
4 commission may authorize to allow for more timely and efficient cost recovery. The
5 commission may prescribe modified rate filing packages for these alternative
6 methodologies.

7 (b) **Multi-step rates.** The commission may establish multi-step rates in accordance with this
8 subsection to allow a utility to implement one or more rates over time without filing
9 multiple rate applications.

10 (1) Multi-step rates may only be established in a comprehensive rate proceeding under
11 Texas Water Code (TWC) §13.187, 13.1871, or 13.18715.

12 (2) The commission may establish multi-step rates on its own motion or at the request
13 of a utility or any other interested party.

14 (3) Rates established in a comprehensive rate case under TWC §13.187, 13.1871, or
15 13.18715 will replace any multi-step rates already in effect or previously approved
16 by the commission to go into effect for that utility.

17 (4) The commission may establish multi-step rates when a utility transitions from use
18 of flat rates for unmetered service to use of variable rates for metered service.

19 (A) Multi-step rates for a utility's transition to metered service cannot be
20 effective before the date that meters are installed and in operation for all the
21 utility's connections.

1 (B) If the utility is seeking multi-step rates, the utility must state in its notice of
2 intent to change rates that it is seeking permission to use multi-step rates to
3 transition to metered service with variable usage rates.

4 (C) The utility must provide notice to its customers at least 30 days before the
5 utility begins charging its variable usage rate for metered service and at least
6 30 days before implementation of each step of its commission-approved
7 multi-step rate.

8 (5) The commission may establish multi-step rates when a utility transitions from
9 multiple rate schedules for different systems or service areas to consolidated rate
10 schedules for regional or system-wide rates.

11 (A) The commission may establish different rates and a different timeline for
12 each step in the multi-step rates of each system or service area that is
13 transitioning to a consolidated rate schedule provided that the final step for
14 each system or service area is the same consolidated rate.

15 (B) If the utility is seeking multi-step rates, the utility must state in its notice of
16 intent to change rates that it is seeking permission to use multi-step rates to
17 transition from multiple rate schedules for different systems or service areas
18 to consolidated rate schedules for regional or system-wide rates.

19 (C) The utility must provide notice to its customers at least 30 days before
20 implementation of each step of its commission-approved multi-step rate.

21 (6) The commission may establish multi-step rates to moderate the effects of a rate
22 increase on customers or if other good cause exists.

1 (A) The commission may establish different rates and a different timeline for
2 each step in the multi-step rates for each of a utility's systems or service
3 areas provided that the final step for each system or service area is the same
4 final rate.

5 (B) If the utility is seeking multi-step rates, the utility must state in its notice of
6 intent to change rates that it is seeking permission to use multi-step rates.

7 (C) The utility must provide notice to its customers at least 30 days before
8 implementation of each step of its commission-approved multi-step rate.

9 (7) The commission may place conditions on the implementation of a multi-step rate
10 or on any step of a multi-step rate. For the purpose of ensuring just and reasonable
11 rates, the commission may terminate a multi-step rate before completion of all steps
12 of the multi-step rate.

13 (c) **Cash needs method.** The commission may approve use of the cash needs method to
14 establish a utility's revenue requirement in a comprehensive rate proceeding for a Class C
15 or D utility under TWC §13.1871 if the method will allow the utility to provide continuous
16 and adequate service or other good cause exists to support the use of the cash needs method.
17 Under the cash needs method, the allowable components of cost of service are operating
18 expenses, debt service costs, and an additional margin consisting of either an operating
19 margin or an incremental revenue amount.

20 (1) **Operating expenses.** Only those operating expenses that are reasonable and
21 necessary to provide service may be recovered, and these amounts must be based
22 on the utility's test year expenses, adjusted for known and measurable changes.

1 (2) **Debt-service costs.** Debt service costs include principal and interest payments on
2 the utility's debt.

3 (A) The debt must have reasonable terms and must finance facilities that will be
4 used and useful in the provision of utility service.

5 (B) Debt-service costs may include amounts placed in a debt service reserve
6 account or an escrow account if required by the commission, Texas Water
7 Development Board, other state or federal agency, or financial institution.

8 (C) Debt-service costs may include owner-financed assets. Debt-service costs
9 related to these assets must include debt repayments using a reasonable
10 amortization schedule and must use the prime interest rate at the time the
11 application is filed.

12 (3) **Additional margin.** An additional margin consists of either an operating margin
13 or an incremental revenue amount. A utility requesting an additional margin must
14 provide an explanation for the magnitude of the additional margin it requests. If a
15 utility requesting an additional margin in the form of an operating margin has filed
16 its most recent required annual report and has a net plant (original cost of plant in
17 service less accumulated depreciation) of less than 25 percent of the original cost
18 of plant, an operating margin of up to five percent of operating expenses approved
19 by the commission will be presumed reasonable and may be included in the utility's
20 revenue requirement. An additional margin consisting of an incremental revenue
21 amount is calculated by adding an incremental amount to the debt service costs
22 described in paragraph (c)(3)(A) of this section to achieve a reasonable total debt
23 service coverage level above 1.0.

1 (4) **Restrictions.** If a utility's rates are established using the cash needs method under
2 this subsection, the utility's rates may not be subsequently set using a cost of service
3 calculated under §24.41 of this title (related to Cost of Service) for any
4 comprehensive rate change application filed within five years after the date of the
5 commission's order establishing rates using the cash needs method. If, after this
6 five-year period, the utility has a comprehensive rate change proceeding based on
7 a cost of service calculated under §24.41 of this title, the utility's rate base must
8 exclude an amount equal to the principal paid during the time that rates based on
9 the cash needs method were in effect.

10 (5) **Subsequent acquisition.** If a utility with rates established using the cash needs
11 method is acquired by another utility while such rates are in effect, the acquiring
12 utility is not subject to the restriction in paragraph (4) of this subsection on
13 calculating cost of service. If the acquiring utility files a comprehensive rate change
14 application based on a cost of service calculated under §24.41 of this title, the
15 acquiring utility must exclude from rate base an amount equal to the principal paid
16 that was related to the acquired utility during the time that rates based on the cash
17 needs method were in effect.

18 (d) **New customer classes.** A utility may request the addition of a new customer class or
19 classes as provided by this subsection.

20 (1) **Application.** An application for new customer classes under this section must
21 include:

22 (A) a cost-of-service study for each proposed new class;

23 (B) a definition for each proposed new customer class;

- 1 (C) demonstration that the characteristics of each proposed new class are
2 sufficiently different from the characteristics for all existing and other
3 proposed new classes for different rate treatment;
- 4 (D) a request for service from a customer of each proposed new class; and
- 5 (E) documentation that the revenues to be recovered from each new customer
6 class will be less than ten percent of the utility's total annual revenue if the
7 utility wants to extend the 18 month deadline to file a comprehensive rate
8 case under paragraph (3) of this subsection.

9 (2) **Rates for new customer classes.**

- 10 (A) The rates for each new customer class must be based on a commission-
11 approved cost-of-service study.
- 12 (B) On the effective date of the rates for each new customer class, common
13 costs assigned to and recovered from the new rate classes must be removed
14 from the rates of existing customer classes.

15 (3) **Rate case requirement.** A utility that has received commission approval for the
16 creation of a new rate class or classes under this subsection must file a
17 comprehensive rate case by filing a statement of intent under TWC §13.187,
18 13.1871 or 13.18715 not later than 18 months from the date service begins to the
19 new rate class or classes. If the utility demonstrates to the commission that each
20 new customer class represents less than ten percent of the utility's total annual
21 revenue, a comprehensive rate case is not required until the earlier of six months
22 following the date on which the revenues of the customer class or classes equals or
23 exceeds ten percent of the utility's total annual revenue, or five years following the

1 date service to the new rate class or classes begins. If the utility makes this
2 demonstration under subparagraph (1)(E) of this subsection, the utility must, as an
3 attachment to its annual report filed under §24.129 (relating to Water and Sewer
4 Utilities Annual Reports), annually update its demonstration to show that the
5 revenues of each new customer class remain less than ten percent of the utility's
6 total annual revenue. If a utility fails to provide an annual update that shows the
7 annual revenue of each new customer class remains less than ten percent of the
8 utility's total annual revenue, the utility must file a comprehensive rate case within
9 six months of the date its annual report was due under §24.129(a), or five years
10 from the original approval of the new customer class, whichever comes first.
11

1 **§24.76. System Improvement Charge.**

2 (a) **Purpose.** This section establishes the requirements for a system improvement charge to
3 ensure timely recovery of infrastructure investment.

4 (b) **Definitions.** In this section, the term eligible plant means plant properly recorded in the
5 National Association of Regulatory Utility Commissioners System of Accounts, accounts
6 304 through 339 for water utility service or accounts 354 through 389 for sewer utility
7 service.

8 (c) **System improvement charge.** A system improvement charge is a charge to recover the
9 cost of a utility's eligible plant that is used and useful and the costs of which are not already
10 included in the utility's rates. A utility must have only one system improvement charge in
11 effect for water and one system improvement charge in effect for sewer at any time. A
12 utility may apply for amendments to the charge. The commission may approve a system
13 improvement charge as a multi-step increase if necessary to limit the utility's annual total
14 revenue increase to no more than 10 percent.

15 (d) **Eligibility to apply for a system improvement charge.**

16 (1) A utility may not apply for a system improvement charge if it has a multi-step base
17 rate increase in effect.

18 (2) A utility may not apply for a system improvement charge while it has a
19 comprehensive rate proceeding under TWC §13.187, 13.1871, 13.18715, or
20 13.1872 pending before the commission.

21 (3) A utility may not apply for a system improvement charge until 12 months after a
22 commission order establishing rates in a proceeding under TWC §13.187, 13.1871,
23 13.18715, or 13.1872 is final and appealable.

(4) If a utility with a pending application for a system improvement charge files an application to change rates under TWC §13.187, 13.1871, 13.18715, or 13.1872, or the commission initiates a rate change review under TWC §13.186, the utility will be deemed to have withdrawn its application for a system improvement charge and the presiding officer must dismiss the application.

(e) **Application.** An application to establish or amend a system improvement charge must include the following:

(1) a description of the eligible plant for which cost recovery is sought through the system improvement charge, including the project or projects included in the request and an explanation of how each project has improved or will improve service;

(2) a calculation of the system improvement charge in accordance with subsection (f) of this section and all supporting calculations and assumptions for each component of the system improvement charge;

(3) invoices and receipts showing the cost of eligible plant;

(4) the utility's most recent annual report filed with the commission, which must be the annual report most recently due for filing; and

(5) an affidavit confirming that the application meets the requirements of this section.

(f) **Calculation of the system improvement charge.**

(1) The system improvement charge must be calculated using the following formula:

$$\text{SIC} = (\text{Eligible Cost} * \text{ROR}) + \text{Federal Income Taxes} + \text{Depreciation} + \text{ad valorem taxes} + \text{other revenue related taxes}.$$

Where:

1 **SIC** = the system improvement charge.

2 **Eligible Cost** = the original costs of eligible plant that have not been included in
3 the calculation of a rate other than the system improvement charge, less any
4 accumulated depreciation.

5 **Accumulated depreciation** = depreciation accumulated for eligible plant after the
6 date the eligible plant was placed in service.

7 **ROR** = after-tax rate of return as defined in subparagraph (A) of this paragraph.

8 **Federal Income Taxes** = current annual federal income tax, as related to eligible
9 costs.

10 **Depreciation** = current annual depreciation expense for the eligible plant.

11 **Ad Valorem Taxes** = taxes based on the assessed value of the eligible plant.

12 **Other Revenue Related Taxes** = any additional taxes resulting from the utility's
13 increased revenues related to the SIC.

14 (A) The after-tax rate of return is one of the following:

15 (1) if the final order approving the rate of return was filed less than three
16 years before the application for a system improvement charge was
17 filed, the after-tax rate of return is the one approved by the
18 commission in the utility's last base-rate case; or

19 (2) if the final order approving the rate of return was filed three years or
20 more before the application for a system improvement charge was
21 filed, the after-tax rate of return is the average of the commission's
22 approved rates of return for water and sewer utilities over the three

1 years immediately preceding the filing of the system improvement
2 charge application.

3 (g) **Notice.** By the first business day after it files its application, the utility must send notice
4 of its system improvement charge application to all affected ratepayers by first class mail,
5 e-mail (if the customer has agreed to receive communications electronically), bill insert, or
6 hand delivery. The utility must include in the notice the intervention deadline and the
7 docket number for the utility's system improvement charge proceeding. The intervention
8 deadline is 25 days from the date service of notice is complete.

9 (h) **Commission processing of application.** Upon the filing of an application to establish a
10 system improvement charge, the presiding officer must set a procedural schedule that will
11 enable the commission to issue a final order within 120 days after the application is
12 determined to be sufficient if no hearing is requested.

13 (1) For good cause, the presiding officer may set a schedule that will not enable
14 issuance of a final order within 120 days after the application is determined to be
15 sufficient. The deadlines established by the presiding officer will be extended as
16 provided in this subsection.

17 (2) After an application is determined to be sufficient, the applicant must respond to
18 requests for information within 10 days. The deadline for final action is extended
19 one day for each day that a response exceeds 10 days.

20 (3) A request by an intervenor for hearing must be filed within 25 days after the
21 application is determined to be sufficient. A request for hearing must state with
22 specificity the issues to be addressed.

1 (4) Unless an intervenor requests a hearing, commission staff must submit a
2 recommendation on the application or request a hearing not later than 45 days after
3 the application is determined to be sufficient unless commission staff requests
4 additional time, not to exceed another 15 days unless good cause exists for a later
5 date. If commission staff is granted additional time, the deadline for final action is
6 extended day for day for each day of additional time.

7 (5) If a hearing on the application is requested, the application will be referred to the
8 State Office of Administrative Hearings (SOAH) for an evidentiary hearing. The
9 presiding officer must set a procedural schedule that will enable the commission to
10 issue a final order within 120 days after the application is referred to SOAH. For
11 good cause, the presiding officer may set a procedural schedule that will not enable
12 the commission to issue a final order within 120 days after the application is
13 determined to be sufficient.

14 (i) **Scope of proceeding.** The issue of whether eligible costs included in an application
15 for a system improvement charge or an amendment to a system improvement
16 charge are prudent, reasonable, or necessary, will not be addressed in a proceeding
17 under this section unless the presiding officer finds that good cause exists to address
18 these issues.

19 (j) **System improvement charge reconciliation.** Costs recovered through a system
20 improvement charge are subject to reconciliation in the utility's next comprehensive rate
21 case. Any amounts recovered through the system improvement charge that are found to
22 have been unreasonable, unnecessary, or imprudent, plus the corresponding return and
23 taxes, must be refunded with carrying costs. The utility must pay to its customers carrying

1 costs on these amounts calculated using the same rate of return that was applied to the
2 recovered costs in establishing the system improvement charge until the date the rates
3 approved utility's next comprehensive rate case are effective. Thereafter, carrying costs
4 must be calculated using the utility's rate of return authorized in the comprehensive rate
5 case.

6 (k) **Requirement to file a rate case.** A utility must file a comprehensive rate case under TWC
7 §13.187, 13.1871, 13.18715, or 13.1872 within the following times from the date the
8 commission files an order approving the system improvement charge.

9 (1) Four years for a Class A utility.

10 (2) Six years for a Class B utility.

11 (3) Eight years for a Class C or Class D utility.